

N. IRC 4945 -- SCHOLARSHIP GRANTS TO INDIVIDUALS AND THE VALIDITY OF RACIALLY RESTRICTED SCHOLARSHIP TRUSTS

1. Introduction

This topic provides a review of the "taxable expenditure" provisions of IRC 4945 that are applicable to scholarship grants. It also considers the effect of racial limitations on private scholarship trusts for purposes of exemption qualification under IRC 501(c)(3) and grant approval under IRC 4945(g)(1). Material covered in the 1980 Annual Technical Review Institutes and the 1981 Continuing Professional Education Technical Instruction Program is restated and updated.

2. IRC 4945: In General

IRC 4945 was enacted as part of the Tax Reform Act of 1969, P.L. 91-172, 1969-3 C.B. 10. Some of the concern underlying enactment of this code provision was that many private foundations were distributing funds to individuals without conditions and controls that would ensure expenditure of the funds exclusively for exempt purposes or recovery of the funds in the event of misapplication. IRC 4945, which defines five types of taxable expenditures, was enacted to deal with these concerns. IRC 4945(d) provides that:

The term "taxable expenditure" means any amount paid or incurred by a private foundation --

- (1) to carry on propaganda, or otherwise to influence legislation, within the meaning of IRC 4945(e),
- (2) except as provided in IRC 4945(f), to influence the outcome of any specific public election, or to carry on, directly or indirectly, any voter registration drive,
- (3) as a grant to an individual for travel, study, or other similar purposes by such individual, unless such grant satisfies the requirements of IRC 4945(g),
- (4) as a grant to an organization (other than an organization described in paragraph (1), (2), or (3) of IRC 509(a)),

unless the private foundation exercises expenditure responsibility with respect to such grant in accordance with IRC 4945(h), or

(5) for any purpose other than one described in IRC 170(c)(2)(B).

IRC 4945(a) and (b) impose a two-level tax on taxable expenditures. An initial 10 percent tax is to be paid by the private foundation and an additional 100 percent tax is assessed if the expenditure is not timely corrected. Also, a 2 1/2 percent tax is imposed on any foundation manager knowingly agreeing to the making of a taxable expenditure, and a 50 percent tax is assessed on any foundation manager who refuses to make part or all of the correction.

This topic will now consider the IRC 4945 grant-making requirements applicable to scholarships.

3. Scholarship Approval Under IRC 4945(g)

IRC 4945(g)(1) excludes from the term "taxable expenditure" scholarship grants that are subject to the provisions of IRC 117(a) and are to be used for study at an educational institution described in IRC 170(b)(1)(A)(ii). IRC 4945(g) provides further that these individual grants must be provided on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the Secretary.

A. Advance Approval

Advance approval of scholarship procedures is required under IRC 4945(g). Grants made prior to receiving approval constitute taxable expenditures under IRC 4945(d)(3) even if all other requirements are met. Procedural guidelines for requesting advance approval are set forth in Reg. 53.4945-4(d). Approval of grant procedures is effective so long as the requesting foundation makes no material changes in its procedures.

In further regard, as IRM 7666.3 indicates, key districts are required to refer to the National Office IRC 501(c)(3) application cases that contain IRC 4945(g) grant approval issues. This is usually the case where the applicant organization appears to be a private foundation within the meaning of IRC 509(a) and scholarship awards are one of the activities of the organization. This manual

provision was adopted to insure that private foundations subject to advance approval requirements would obtain such approval at the time of exemption qualification.

B. Special Rules

One should be familiar with certain reliance or savings provisions as they relate to IRC 4945(g) advance approval requirements.

1. Transitional Rules

The first of these rules provides that a grant made pursuant to a commitment in effect prior to January 1, 1970 will not be subject to IRC 4945(d)(3) where it was made in accordance with a foundation's usual practices and was reasonable in amount. The second rule provides special treatment for grants awarded prior to January 30, 1973, and paid within 48 months after the award of the grant. Generally, these grants are deemed approved under IRC 4945(g). See Reg. 53.4945-4(e)(2).

2. 45-Day Rule

Reg. 53.4945-4(d)(3) provides that:

If by the 45th day after a request for approval of grant procedures has been properly submitted to the Internal Revenue Service, the organization has not been notified that such procedures are not acceptable, such procedures shall be considered as approved from the date of submission until receipt of actual notice from the Internal Revenue Service that such procedures do not meet the requirements of this section. If a grant to an individual for a purpose described in IRC 4945(d)(3) is made after notification to the organization by the Internal Revenue Service that the procedures under which the grant is made are not acceptable, such grant is a taxable expenditure under this section.

In a number of similar cases, the 45-day rule has been applied in the following situation: An organization has filed Form 1023 after 1969, including a description of its grant-making procedures. Subsequently, an exemption letter was issued containing no mention of the organization's grant-making procedures. Some years later, it was discovered during an audit that the organization had never received written advance approval under IRC 4945(g). In this circumstance, the

45-day rule has been held to apply, so that any grants made after the Form 1023 was filed are considered approved until either (1) there is a material change in the grant-making procedures, or (2) the organization receives actual notice that its procedures are acceptable. This example illustrates the importance of IRM 7666.3.

On the other hand, the 45-day rule will not apply where the existence of a grant-making program is acknowledged by an agent during an audit, but the organization fails to make any written request for advance approval. The oral statements made to the agent would not constitute a request for advance approval.

Rev. Rul. 81-46, 1981-1 C.B. 514, illustrates application of the 45-day rule in two situations where the private foundation's grant procedures were disapproved. In the first situation, the remaining installments of a foundation's fixed-sum grants, awarded during the period its procedures were deemed approved by virtue of the 45-day rule, were not taxable expenditures. Remaining installment payments were made after the notice of disapproval by the Service. In the second situation, renewals of grants deemed approved prior to the notice of disapproval were held to be taxable expenditures. This was the case because the renewals were in the discretion of the foundation and therefore were considered new grants.

The text of Rev. Rul. 81-46 follows:

Private foundation; taxable expenditure; educational grants request for approval. A private foundation submitted a request for approval of its grant-making procedures to the Service, did not receive a reply within 45 days, and considered the procedures to be approved under section 53.4945-4(d)(3) of the regulations. Later, the foundation was notified by the Service that its grant-making program did not conform to the requirements of section 4945(g) of the Code. After receipt of the disapproval notification, the remaining installments of fixed-sum grants awarded during the period the foundation's procedures were deemed approved are not taxable expenditures; however, the renewals of any grants awarded during such period are taxable expenditures.

Rev. Rul. 81-46

ISSUE

Are grants made by a private foundation in the two situations described below to grant recipients after the foundation's receipt of notification from the Internal Revenue Service that its grant-making program does not conform to the

requirements of section 4945(g) of the Internal Revenue Code taxable expenditures under section 4945(d)(3)?

FACTS

A private foundation exempt from federal income tax under section 501(c)(3) of the Code established a program of awarding grants for educational purposes. Before awarding any grants under this program, the foundation properly submitted a request for approval of its grant-making procedures to the Service.

The foundation was not notified within 45 days from the date of the submission of its request that its procedures were not acceptable. As a result, the procedures were considered to have been approved from the date of submission under section 53.4945-4(d)(3) of the regulations on Foundation and Similar Excise Taxes.

Situation 1.

The foundation awarded several fixed-sum grants during the period in which its grant-making procedures were deemed approved under section 53.4945-4(d)(3) of the regulations. Payments in satisfaction of each grant were scheduled to be made in installments over a period of time extending past one year. After awarding the grants, but prior to the completion of payments in satisfaction of them, the foundation was notified that its grant-making procedures did not conform to Service requirements. The foundation proposes to pay the remaining installments of the fixed-sum grants.

Situation 2.

The foundation awarded several grants during the period in which its grant-making procedures were deemed approved under section 53.4945-4(d)(3) of the regulations. After awarding the grants, the foundation was notified that its grant-making procedures did not conform to Service requirements and that future awards pursuant to these procedures would be taxable expenditures. The foundation proposes to renew some of the grants awarded during the period in which its grant-making procedures were deemed approved under section 53.4945-4(d)(3).

LAW AND ANALYSIS

Section 4945 of the Code imposes a tax on each taxable expenditure made by a private foundation.

Section 4945(d)(3) of the Code provides that the term "taxable expenditures" includes any amount paid or incurred by a private foundation as a grant to an individual for travel, study, or other similar purposes except as provided in section 4945(g).

Section 4945(g) of the Code provides that a grant to an individual for study that is made on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the Secretary is not a taxable expenditure under section 4945(d)(3) if it is demonstrated to the satisfaction of the Secretary that (1) the grant constitutes a scholarship or fellowship grant which is subject to the provisions of section 117(a) and is to be used for study at an educational organization described in section 170(b)(1)(A)(ii), (2) the grant constitutes a prize or award that is subject to the provisions of section 74(b), if the recipient of such prize or award is selected from the general public, or (3) the purpose of the grant is to achieve a specific objective, produce a report or other similar product, or improve or enhance a literary, artistic, musical, scientific, teaching, or other similar capacity, skill, or talent of the grantee.

Section 53.4945-4(a)(3)(ii) of the regulations provides the general rule for the making of grants that will not be taxable expenditures under section 4945(d)(3) of the Code and includes the requirement that the grant be made pursuant to procedures approved in advance by the Commissioner.

Section 53.4945-4(a)(3)(iii) of the regulations provides a special rule for the renewal of grants which satisfied the requirements of sections 53.4945-4(a)(3)(ii). Generally such renewals are not treated as grants to individuals and subject to the requirements of section 53.4945-4 if: (1) the foundation has no information that the original grant was improperly used; (2) the reports required in the original grant have been furnished; and (3) the foundation's renewal procedures are objective and nondiscriminatory.

Section 53.4945-4(d)(3) of the regulations provides that if, by the 45th day after a request for approval of grant procedures has been properly submitted to the Service, the organization has not been notified that such procedures are not acceptable, such procedures shall be considered as approved from the date of submission until receipt of actual notice from the Service that such procedures do not meet the requirements of section 4945(g) of the Code. If a grant to an

individual for a purpose described in section 4945(d)(3) is made after notification to the organization by the Service that the procedures under which the grant is made are not acceptable, such grant is a taxable expenditure.

Situation 1.

In Situation 1 the question is whether payment of the remaining installments of the fixed-sum grants will result in taxable expenditures under section 4945(d)(3) of the Code. Since the grants described in Situation 1 were made during the period that the foundation's procedures were deemed approved, they are not taxable expenditures. Payment of the remaining installments, even after notification by the Service that the procedures were not acceptable, will not be considered to be awarding of new grants but merely the satisfaction of the foundation's obligation under the grants that were deemed approved. Accordingly, paying the remaining installments will not result in taxable expenditures under section 4945(d)(3).

Situation 2.

In Situation 2, the question presented is whether a renewal of any grant that the foundation awarded during the period that its procedures were deemed approved under section 53.4945(d)(3) of the regulations will result in a taxable expenditure under section 4945(d)(3) of the Code. Unlike the installment payments considered in Situation 1, the grant renewals considered in Situation 2 are within the discretion of the foundation and are in essence new grants. Section 53.4945-4(a)(3)(iii) of the regulations provides a simplified procedure for renewals when the full and proper grant-making procedures have been followed in making the original grant. This section recognizes that it would be burdensome and unnecessary for the foundation to repeat the original grant-making procedures for every renewal unless it has knowledge that the original grant was misused or that the requirements of the original grant have not been met. The simplified procedure is available, however, only when the requirements for an original grant, as set forth in section 53.4945-4(a)(3)(ii), have once been met. Therefore, once the Service has determined and notified the foundation that its grant-making procedures are defective any renewal grants awarded after receipt of that notice would be taxable expenditures under section 4945(d)(3).

HOLDINGS

In Situation 1, the payment by the foundation of the remaining installments of fixed-sum grants awarded during the period the foundation's procedures were

deemed approved under section 53.4945-4(d)(3) of the regulations, after the foundation's receipt of notification from the Service that its grant-making program does not conform to the requirements of section 4945(g) of the Code, are not taxable expenditures under section 4945(d)(3).

In Situation 2, the renewals of any grants that the foundation awarded during the period that its procedures were deemed approved under section 53.4945-4(d)(3) of the regulations, after the foundation's receipt of notification from the Service that its grant-making program does not conform to the requirements of section 4945(g) of the Code, are taxable expenditures under section 4945(d)(3).

C. Requirement of a Proper Procedure

In order to receive advance approval of its grant-making procedures, a foundation must demonstrate that:

1. its grant procedure includes an objective and nondiscriminatory selection process;
2. such procedure is reasonably calculated to result in performance by grantees of the activities that the grants are intended to finance; and,
3. the foundation plans to obtain reports to determine whether the grantees have performed the activities that the grants are intended to finance.

No single procedure or set of procedures is required. Procedures may vary depending upon such factors as the size of the foundation, the amount and purpose of the grants, and whether one or more recipients are involved.

The procedural requirements are given in detail in Reg. 53.4945-4(b) and (c).

1. Objective and Nondiscriminatory Basis

This requirement concerns whether grants are awarded in a manner that is consistent with exempt status under IRC 501(c)(3) provisions and relates to who is eligible for the grants, how the grantee is chosen, and who

makes the selection. Ordinarily, the group from which the grantee is chosen must be large enough to constitute a charitable class.

Secondly, selection of the grantee from among the candidates should be related to the purposes of the grant. Criteria for choosing a scholarship recipient can include academic performance, performance on college entrance exams or similar tests, recommendations, financial need, and personal qualities.

Finally, the persons selecting the grantee should not be in a position to derive a private benefit from the selection. Such benefit could arise if the persons choose their relatives to receive the grant. Similarly, if the program is a company-related scholarship program, awarding of a disproportionate number of grants to highly compensated employees or their children could violate this provision.

2. Other Procedural Requirements

The other procedural requirements under IRC 4945(g) are intended to insure that a private foundation's grants are used for their intended purpose. The foundation's procedures must include a follow-up mechanism to review the use of the grant and investigate any misuse of funds. See Reg. 53.4945-4(c).

Special rules apply to scholarship and fellowship grants. If the award is made directly to the student, the foundation must receive a report of his/her courses and grades from the educational institution at least once a year. If the individual is not attending school, a yearly progress report must be made.

When a foundation pays a scholarship directly to an educational institution that agrees to supervise the use of the grant, the foundation need not adopt the type of procedures discussed above. Reg. 53.4945-4(c)(5). A private foundation must also maintain records with respect to individual grants. This includes the information used to evaluate the qualifications of potential grantees, a complete identification of the grantees selected, the amount and purpose of each grant, and all grantee reports and other follow-up data in administering the foundation's grant program. See. Reg. 53.4945-4(c)(6).

4. Company Scholarship and Loan Programs

A. Rev. Proc. 76-47 and Rev. Proc. 80-39

An employer-related grant or loan program is one that treats some or all of the employees, or children of some or all of the employees, of a particular employer as a group from which grantees of some or all of the foundation's scholarships or loans will be selected. Usually foundations with such programs are created and funded by the particular employer to which the grant program relates. The rules for determining whether grants made under an employer-related program constitute scholarships or fellowships under IRC 117 are set forth in Rev. Proc. 76-47, 1976-2 C.B. 670. In addition, guidelines for determining whether educational loans made by a private foundation are taxable expenditures under IRC 4945(g) are set forth in Rev. Proc. 80-39, 1980-2 C.B. 772. These guidelines are similar to those established in Rev. Proc. 76-47.

Both revenue procedures follow:

26 CFR 601.602: Forms and instructions. (Also Part I, Sections 117, 4945; 1.117-1, 53.4945-4.)

Rev. Proc. 76-47

Section 1. Purpose.

A grant by a private foundation to an individual for travel, study, or other similar purpose by such individual is a "taxable expenditure" by the private foundation for purposes of the tax imposed by section 4945 of the Internal Revenue Code of 1954 unless such grant satisfies the requirements of section 4945(g) of the Code. Section 4945(d)(3). Such a grant, awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance, by the Secretary or the Secretary's delegate, may satisfy the requirements of section 4945(g)(1) if it is demonstrated to the satisfaction of the Secretary or the Secretary's delegate that the grant is a scholarship or fellowship grant that is subject to the provisions of section 117(a) and is to be used for study at an educational institution described in section 151(e)(4).

Ruling requests seeking advance approval of procedures are to be submitted to Assistant Commissioner (Employee Plans and Exempt Organizations), Attention

E:EO:T, Washington, D.C. 20224, and should include the statements described in section 53.4945-4(d) of the Foundation Excise Tax Regulations

The purpose of this Revenue Procedure is to provide guidelines to be used in determining whether a grant made by a private foundation under an employer-related grant program to an employee or to a child of an employee of the particular employer to which the program relates is a scholarship or fellowship grant subject to the provisions of section 117(a) of the Code.

If the private foundation's educational grants are not scholarships or fellowship grants subject to the provisions of section 117(a) of the Code and do not otherwise qualify under the provisions of section 4945(g)(2) or (3), they would be "taxable expenditures" within the meaning of section 4945(d) and might, depending upon the circumstances, lead to a loss of the private foundation's exempt status. As hereinafter explained, grants made by a foundation under an employer-related grant program to employees, or to children of employees of the particular employer to which the program relates could fail to be section 117 scholarships or fellowship grants because, for example, the purpose of the program is to provide extra compensation, an employment incentive, or an employee fringe benefit for the employees generally or a particular class of employees. Such a purpose would not be consistent with the foundation's exempt purpose or the allowance of deductions under section 170 for contributions to it.

The guidelines are directed only to the foregoing question of qualification under section 117 of the Code. For example, they are not directed to whether the private foundation's employer-related grant program meets the rules of section 53.4945-4(b) of the regulations requiring that the foundation's program be consistent with its exempt status and the allowance of deductions to individuals under section 170 for contributions to the foundation and that the group from which grantees are selected is a "charitable class." The guidelines assume that those requirements have been met except insofar as that conclusion may be affected by the failure of the educational grants to be scholarships or fellowships subject to the provisions of section 117(a) and the reason for such failure.

Thus, for example, these guidelines assume that the group of employees, or children of employees, from which grantees are to be selected is sufficiently broad so that the awarding of grants to members of such a group could be considered consistent with the fulfillment of a purpose described in section 170(c)(2)(B) of the Code and the group could be considered to be a charitable class.

In addition, these guidelines are not directed to whether or not, if programs permit disqualified persons to receive grants, such grants constitute taxable expenditures under section 4945 of the Code or subject the disqualified persons to tax under section 4941.

Sec. 2. Application of Guidelines.

These guidelines apply to educational grants made on or after January 1, 1970, by a private foundation under an employer-related grant program to individuals who are employees, or the children of employees, of the employer to which the program relates.

An employer-related program is a program that treats some or all of the employees, or children of some or all of the employees, of a particular employer as a group from which grantees of some or all of the foundation's educational grants will be selected, limits the potential grantees for some or all of the foundation's grants to individuals who are employees, or children of employees, of a particular employer or otherwise gives such individuals a preference or priority over others in being selected as grantees of such grants.

These guidelines apply only to cases in which the group of employees, or children of employees, of the particular employer to which the program relates, from which grantees are to be selected, is sufficiently broad so that the awarding of grants to members of such a group could be considered consistent with the fulfillment of a purpose described in section 170(c)(2)(B) of the Code and the group could be considered to be a charitable class.

Sec. 3. Background

Section 117 of the Code provides that gross income does not include any amount received as a scholarship or as a fellowship grant at an educational institution (as defined in section 151(e)(4)). Section 1.117-3 of the Income Tax Regulations states that a scholarship generally means an amount paid or allowed to, or for the benefit of, a student to aid that student in pursuing studies. A fellowship grant is defined as an amount paid or allowed to, or for the benefit of, an individual to aid the individual in the pursuit of study or research.

Section 1.117-4(c) of the regulations explains that any amount paid or allowed to, or on behalf of, an individual to enable that individual to pursue studies or research is nevertheless not a scholarship or a fellowship grant for purposes of

section 117 of the Code if such amount represents compensation for past, present, or future employment services or if such studies or research are primarily for the benefit of the grantor. In the context of section 1.117-4(c), "benefit" is not limited to monetary gain. See Jerry S. Turem, 54 T.C. 1949 (1970). It may include anything that furthers a noneducational purpose of a grantor. By contrast, a grant made for the relatively disinterested purpose of financially assisting an individual to pursue an education for that individual's own benefit may qualify as a section 117 scholarship or fellowship. The determination must, of course, be made in light of all the relevant facts and circumstances.

When educational grants are made available by an employer to its employees on a preferential basis, the employer-employee relationship is immediately suggestive that the grant is compensatory. See Bingler v. Johnson, 394 U.S. 741 (1969), 1969-2 C.B. 17. Such preferential grants by an employer to the children of employees suggests a purpose to compensate or otherwise provide an employment incentive to the employee-parents. These suggestions are not dispelled simply because the grantor is an independent third party (for example, a foundation). The employer-related preferential treatment does not, of itself, further in any way the requisite (under section 117 of the Code) disinterested purpose of simply making it financially possible for individuals to obtain an education for their own personal benefit, and suggests the presence of a contrary purpose to provide extra compensation, an employment incentive, or an employee fringe benefit. If a grant program by a private foundation is designed or administered to that end, the grants made under it to the employees or their children will not be scholarships or fellowship grants subject to the provisions of section 117(a).

The Internal Revenue Service will not, however, treat a private foundation's program as designed or administered for such a purpose if the availability of grants to employees of [sic] their children fall outside the pattern of employment. In order to be outside the pattern of employment, the availability of grants to employees or their children under the program must be controlled and limited by substantial non-employment related factors to such an extent that the preferential treatment derived from employment does not continue to be of any significance beyond an initial qualifier. Such qualification must not lead to any significant probability that employment will make grants available for a qualified employee or his or her children interested in applying for one. The Service will treat the grants as scholarships or fellowship grants subject to the provisions of section 117(a) of the Code if (1) the availability of the grants falls outside the pattern of employment, and (2) the grants do not otherwise represent compensation for past, present, or future services rendered or to be rendered the foundation or employer by the

employees or their children, and (3) the grants are not for studies or research undertaken primarily for the benefit of the foundation or the employer or for some other purposes not sanctioned by section 117.

Sec. 4. Guidelines.

If a private foundation's program satisfies the seven conditions set forth in section 4.01 through 4.07, below, and meets the percentage test described in section 4.08 applicable to grants to employees' children, or to grants to employees, or to both, as the case may require, the Service will assume the grants awarded under the program to employees, or their children, or to both (if the percentage test is met for each category) will be scholarships or fellowship grants subject to the provisions of section 117(a) of the Code.

If a private foundation's program does not satisfy one or more of the seven conditions set forth in sections 4.01 through 4.07, the Service will not issue a ruling that the grants awarded are scholarships or fellowship grants under section 117 of the Code.

If a private foundation's program satisfies the seven conditions set forth in sections 4.01 through 4.07 below, but does not meet the percentage test of section 4.08 applicable to grants to employees' children or to grants to employees, as the case may be, the question whether the grants awarded to individuals in the category (children or employees) in respect of which the percentage test was not met, are scholarships or fellowship grants subject to the provisions of section 117(a) of the Code will be determined on the basis of all the facts and circumstances. In making this determination, the Service will consider as a substitute for the percentage test of section 4.08 all the relevant facts and circumstances to determine whether the primary purpose of the program is to provide extra compensation or other employment incentive, or whether the primary purpose is to educate recipients in their individual capacities. These facts and circumstances will be considered in the context of the probability that a grant will be available to any eligible applicant

Such relevant facts and circumstances could include the history of the program (such as the source of the program's funding), the courses of study for which the grants are available, any eligibility requirements imposed by the program (other than employment of the applicants or their parents and the age and grade level prerequisites for the studies for which the grants are available), the publicity given the grant program, the degree of independence of the selection

committee, the particular standards used for selection, the specific means used to determine whether those standards have been met, the precise nature of the employee limitation or preference, the number of grants available, the number or [sic] employees or their children who would be eligible for them, the percentage of eligible employees or their children applying for grants who normally (e.g. on an average basis), receive grants under the program, and whether and how many grants are awarded to individuals who do not qualify as employees or children of employees.

.01 Inducement

The programs must not be used by the employer the private foundation, or the organizer thereof, to recruit employees or to induce employees to continue their employment or otherwise follow a course of action sought by the employer.

.02 Selection committee

Selection of grant recipients must be made by a committee consisting wholly of individuals totally independent (except for participation on this committee) and separate from the private foundation, its organizer and the employer concerned. An individual who is a former employee of either the foundation or the employer concerned will not be considered totally independent. Such committees preferably should consist of individuals knowledgeable in the education field so that they have the background and knowledge to properly evaluate the potential of the applicants.

The forwarding of the selections by the independent selection committee to the employer or private foundation for the sole purpose of verifying the eligibility requirements and selection criteria followed by the committee in considering the candidates and in making its selection will not disqualify the program. Any public announcement of the awards, however must be made by the selection committee or by the foundation

Grants must be awarded solely in the order recommended by the selection committee. The number of grants to be awarded may be reduced but may not be increased from the number recommended by the selection committee. Only the committee may vary the amounts of the grants awarded.

.03 Eligibility requirements

The program must impose identifiable minimum requirements for grant eligibility. Such requirements must be related to the purpose of the program and in case of scholarships must limit the independent selection committee's consideration to those employees, or children of employees, who meet the minimum standards for admission to an educational institution (as defined in section 151(e)(4) of the Code) for which the grants are available. No persons will be considered eligible if they would not reasonably be expected to attend such an institution, however, even if they meet such minimum standards.

If an employee must have been employed for some minimum period by the employer to which the program relates to be eligible to receive a grant, or to make that employee's children eligible to receive a grant, the minimum period of employment may not exceed three years. Moreover, eligibility must not be related to any other employment-related factors, such as the employee's position, services, or duties.

.04 Objective basis of selection

Selection of grant recipients must be based solely upon substantial objective standards that are completely unrelated to the employment of the recipients or their parents and to the employer's line of business. Such standards as, but not limited to prior academic performance, performance on tests designed to measure ability and aptitude for higher education recommendations from instructors or other individuals not related to the potential awardees, financial need, and conclusions drawn from personal interviews as to motivation and character, may be utilized.

.05 Employment

A grant may not be terminated because the recipient or the recipient's parent terminates employment with the employer subsequent to the awarding of the grant regardless of the reason for such termination of employment.

If a grant is awarded for one academic year and the recipient must reapply for a grant to continue studies for a subsequent year, the recipient may not be considered ineligible for a further grant simply because that individual or the individual's parent is no longer employed by the employer. If a grant is awarded for a period of more than one academic year, subject to renewal, the standards for renewal must be based solely upon nonemployment related factors such as need and maintenance of scholastic standards. Renewal may not be denied because the recipient or parent has previously terminated employment with the employer. In

such case, the recipient or parent met the employment requirement at the time the grant was first awarded, and no further employment requirement can be effected at the time of each renewal.

At the time the grant is awarded or renewed, there must be no requirement, condition or suggestion, express or implied, that the recipient or parent is expected to render future employment services for the foundation or the employer, or be available for such future employment even though such future employment is at the discretion of the foundation or the employer.

.06 Course of study

The courses of study for which grants are available must not be limited to those that would be of particular benefit to the employer or to the foundation. If the courses of study for which grants are available include one or more that would be of such particular benefit a grant may not be conditioned on the recipient choosing such a course of study; the recipient must have a free choice to use the grant in the pursuit of a course of study for which the grant is otherwise available that is not of particular benefit to the employer or to the foundation.

.07 Other objectives

The terms of the grant and the courses of study for which grants are available must meet all other requirements of section 117 of the Code and the regulations thereunder, and must be consistent with a disinterested purpose of enabling the recipients to obtain an education in their individual capacities solely for their personal benefit and must not include any commitments, understandings or obligations conditional or unconditional, suggesting that the studies are undertaken by the recipients for the benefit of the employer or the foundation or have as their objective the accomplishment of any purpose of the employer or the foundation (even though consistent with its exempt status) other than enabling the recipients to obtain an education in their individual capacities and solely for their personal benefit.

.08 Percentage test

In the case of a program that awards grants to children of employees of a particular employer, the program meets the percentage test if the number of grants awarded under that program in any year to such children does not exceed 25 percent of the number of employees' children who, (i) were eligible, (ii) were

applicants for such grants, and (iii) were considered by the selection committee in selecting the recipients of grants in that year or 10 percent of the number of employees' children who can be shown to be eligible for grants (whether or not they submitted an application) in that year.

In the case of a program that awards grants to employees of a particular employer, the program meets the percentage test if the number of grants awarded under that program in any year to such employees does not exceed 10 percent of the number of employees who, (i) were eligible, (ii) were applicants for such grants, and (iii) were considered by the selection committee in selecting the recipients of grants in that year.

For the purpose of meeting these percentage tests, an employee or child of an employee will be considered eligible only if the individual meets all of the eligibility requirements imposed by the program and such requirements satisfy the conditions of section 4.03 of this Revenue Procedure. Renewals of grants awarded in prior years will not be considered in determining the number of grants awarded in a current year. Grants awarded to children of employees and those awarded to employees will be considered as having been awarded under separate programs for purposes of all of the requirements of this Revenue Procedure whether or not they are awarded under separately administered programs.

Rev. Proc. 80-39

Section 1. Purpose

.01 The purpose of this revenue procedure is to provide guidelines for determining whether educational loans made by a private foundation under an employer-related loan program are taxable expenditures under section 4945 of the Internal Revenue Code.

.02 Ruling requests seeking advance approval of loan procedures are to be submitted to the Assistant Commissioner (Employee Plans and Exempt Organizations), Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, Attention: E:EO:T, and must include the statements required by section 53.4945-4(d) of the Foundation Excise Tax Regulations.

Sec. 2. Background

.01 Rev. Rul. 77-434, 1977-2 C.B. 420, holds that educational loans made by a private foundation on an objective and nondiscriminatory basis, pursuant to a procedure approved in advance by the Secretary or the Secretary's delegate, are individual grants within the meaning of section 4945(g)(3) of the Code. Thus, the loans are not taxable expenditures.

.02 Section 53.4945-4(b) of the regulations provides that a private foundation's grants are made on an objective and nondiscriminatory basis if the foundation's loan program is consistent with its exempt status under section 501(c)(3) of the Code and the allowance of deductions under section 170 for contributions to the foundation.

.03 Educational loans made by a private foundation to employees of a particular company or to their children are made for a purpose inconsistent with the foundation's exempt status under section 501(c)(3) of the Code and the allowance for deductions under section 170 for contributions to the foundation if the loans serve the private interests of the employer, rather than serving charitable purposes. A long-term, low-interest educational loan provided by a private foundation is of substantial value to students who could not obtain them from any source other than the employer-related program. The Service will assume that employer-related educational loans are made on an objective and nondiscriminatory basis, within the meaning of section 4945(g), and thus are not taxable, expenditures, if they meet the guidelines contained in Sec. 4 of this revenue procedure.

Sec. 3. Application of Guidelines

.01 The guidelines in Sec. 4 apply only to educational loans made on or after January 1, 1970, by a private foundation under an employer-related program to individuals who are employees, or the children of employees, of the employer to which the program relates. Rev. Proc. 76-47, 1976-2 C.B. 670, provides guidelines for determining whether a grant made by a private foundation under an employer-related grant program to an employee or to a child of an employee of the particular employer to which the program relates is a scholarship or fellowship grant under section 117 of the Code.

.02 An employer-related program is a program that treats some or all of the employees, or the children of some or all of the employees, of a particular employer as a group from which the recipients of some or all of the foundation's loans will be selected; limits the potential loan recipients for some or all of the foundation's loans to individuals who are employees, or the children of employees,

of the particular employer, or otherwise gives such individuals a preference or priority over others in being selected as loan recipients.

.03 The guidelines assume that the other applicable requirements of section 53.4945-4 of the regulations concerning loans to individuals are met.

.04 These guidelines do not determine whether loans to disqualified persons are taxable expenditures under section 4945 of the Code or would subject the disqualified persons to the tax on acts of self-dealing under section 4941.

Sec. 4. Guidelines

.01 General rule.

If a private foundation's educational loan program satisfies the seven conditions set forth in Secs. 4.03 through 4.09 below, and meets the percentage test described in Sec. 4.10, the Service will assume such loans are not taxable expenditures.

.02 Facts and circumstances test.

1 If a private foundation's loan program satisfies the seven conditions set forth in Secs. 4.03 through 4.09, but does not meet the percentage test of Sec. 4.10, the Service will consider, as a substitute for the percentage test of Sec. 4.10, all the relevant facts and circumstances to determine whether the primary purpose of the program is to further the private interests of the employer, or whether the primary purpose is to educate recipients in their individual capacities. The availability of loans under the program to employees of [sic] their children must be controlled and limited by substantial nonemployment-related factors so that the preferential treatment derived from employment is not of any significance beyond initial qualification for the loan. Such qualification must not lead to any significant probability that employment will make loans available for a qualified employee or his or her children interested in applying for one.

2 Such relevant facts and circumstances include, but are not limited to: the history of the program (such as the source of the program's funding), the courses of study for which the loans are available, any eligibility requirements imposed by the program (other than employment of the applicants or their parents and the age and grade level prerequisites for the studies for which the loans are available), the publicity given the loan program, the degree of independence of the

selection committee, the particular standards used for selection, the specific means used to determine whether those standards have been met, the precise nature of the employee limitation or preference, the number of loans available, the number of employees or their children who would be eligible for the loans, the percentage of eligible employees or their children applying for loans who normally (e.g., on an average basis) receive loans under the program, and whether and how many loans are awarded to individuals who do not qualify as employees or the children of employees.

.03 Inducement.

The program must not be used by the employer, the private foundation, or the creator of the foundation, to recruit employees or to induce employees to continue their employment or otherwise follow a course of action sought by the employer.

.04 Selection committee.

1 Selection of loan recipients must be made by a committee consisting wholly of individuals totally independent (except for participation on this committee) and separate from the private foundation, the foundation's creator, and the relevant employer. An individual who is a former employee of either the foundation or the employer concerned will not be considered totally independent. Such committees preferably should consist of individuals knowledgeable in the educational field so that they have the background and knowledge to evaluate properly the potential of the applicants.

2 The forwarding of the selections by the independent selection committee to the employer or the private foundation for the sole purpose of verifying the eligibility requirements and selection criteria used by the committee in considering the candidates and in making its selection will not disqualify the program. Any public announcement of the awards, however, must be made by the selection committee or by the foundation.

3 Loans must be awarded in the order recommended by the selection committee. The number of loans to be awarded may be reduced but may not be increased from the number recommended by the selection committee. Only the committee may vary the amounts of the loans awarded.

.05 Eligibility requirements.

1 The program must impose identifiable minimum requirements for loan eligibility. Such requirements must be related to the purpose of the program and must limit the independent selection committee's consideration to those employees, or children of employees, who meet the minimum standards for admission to an educational institution (as defined in section 170(b)(1)(A)(ii) of the Code) for which the loans are available. No persons will be considered eligible if they are not reasonably expected to attend such an institution, even if they meet the minimum standards.

2 If an employee must have been employed for some minimum period by the employer to which the program relates to be eligible to receive a loan, or to make that employee's children eligible to receive a loan, the minimum period of employment may not exceed three years. Moreover, eligibility must not be related to any other employer-related factors, such as the employee's position, or duties.

.06 Objective basis of selection.

Selection of loan recipients must be based solely upon substantial objective standards that are completely unrelated to the employment of the recipients or their parents and to the employer's line of business. Acceptable standards include, but are not limited to: prior academic performance, performance on tests designed to measure ability and aptitude for higher education, recommendations from instructors or other individuals not related to the potential loan recipients, financial need, and conclusions drawn from personal interviews as to motivation and character.

.07 Employment.

1 A loan may not be terminated solely because the recipient or the recipient's parent subsequently terminates employment with the employer, regardless of the reason for the termination of employment.

2 If a loan is awarded for one academic year and the recipient must reapply for an additional loan or loans to continue studies in a subsequent year, the recipient may not be considered ineligible for a subsequent loan simply because that individual or the individual's parent is no longer employed by the relevant employer. The standards for additional loans must be based solely upon on employment-related factors such as need and maintenance of scholastic standards.

3 At the time the loan or additional loans are awarded, there must be no requirement, condition or suggestion, express or implied, that the recipient or the recipient's parent is expected to render future employment services for the foundation or the relevant employer, or be available for such future employment, even though such future employment is at the discretion of the foundation or the employer.

.08 Course of study.

The courses of study for which loans are available must not be limited to those that would be of particular benefit to the relevant employer or to the foundation. If the courses of study for which loans are available include one or more that would be of such particular benefit, a loan may not be conditioned on the recipient's choosing such a course of study; the recipient must have a free choice to use the loan in the pursuit of a course of study for which the loan is otherwise available that is not of particular benefit to the employer or to the foundation.

.09 Other objectives.

The terms of the loan and the courses of study for which loans are available must be consistent with a disinterested purpose of enabling the recipients to obtain an education in their individual capacities solely for their personal benefit and they must not include any commitments, understandings or obligations, conditional or unconditional, suggesting that the studies are undertaken by the recipients for the benefit of the relevant employer or the foundation, or have as their objective the accomplishment of any purpose of the employer or the foundation (even though consistent with its exempt status) other than enabling the recipients to obtain an education in their individual capacities and solely for their personal benefit.

.10 Percentage test.

1 In the case of a program that awards loans to children of employees of a particular employer, the program meets this percentage test if the number of children receiving loans under that program in any given year does not exceed 25 percent of the number of employees' children who (i) were eligible, (ii) were applicants for such grants, and (iii) were considered by the selection committee in selecting the recipients of loans in that year, or 10 percent of the number of employees' children who can be shown to be eligible for loans (whether or not they submitted an application) in that year.

2 In the case of a program that awards loans to employees of a particular employer, the program meets this percentage test if the number of employees receiving loans under that program in any year does not exceed 10 percent of the number of employees who (i) were eligible, (ii) were applicants for such grants, and (iii) were considered by the selection committee in selecting the recipients of grants in that year.

3 For the purpose of applying these percentage tests, an employee or child of an employee will be considered eligible only if the individual meets all of the eligibility requirements imposed by the program and such requirements satisfy the conditions of Sec. 4.05 of this revenue procedure. Renewals of loans awarded in prior years will not be considered in determining the number of loans awarded in the current year. Loans awarded to children of employees and those awarded to employees will be considered as having been awarded under separate programs for purposes of all of the applicable requirements of this revenue procedure whether or not the loans are awarded under separately administered programs.

4 If a private foundation's employer-related program encompasses educational loans and scholarship or fellowship grants to the same group of eligible employees or employees' children, the percentage tests in Sec. 4.10 of this revenue procedure apply to the total number of individuals receiving combined grants of scholarships, fellowships, and educational loans.

Sec. 5. Reliance on Pre-September 29, 1980, Ruling Letters

.01 A private foundation that holds a ruling letter issued before September 29, 1980, approving its employer-related educational loan program under section 4945(g)(3) of the Code, may continue to rely on the ruling letter provided its loan program fully complies with Secs. 4.01-4.10 continuously from the date on which the ruling letter was issued. Upon written request, the Service will issue a current ruling letter affirming the qualification of the loan program under the relevant portions of this revenue procedure.

.02 Pursuant to the authority contained in section 7805(b) of the Code, where a private foundation holds a ruling letter issued before September 29, 1980, approving its employer-related educational loan program, and where its loan program does not fully comply with Secs. 4.01-4.10, the private foundation may rely on the ruling letter through March 31, 1981.

.03 Educational loan programs modified to conform with Secs. 4.01-4.10 should be submitted for advance approval under section 4945(g)(3) of the Code in accordance with section 53.4945-4 of the regulations.

B. Additional Consideration's

The guidelines set forth in these revenue procedures were established to insure that employer-related scholarship and loan programs do not exist for the purpose of providing extra compensation, an employment incentive, or an employee fringe benefit program. It should be observed that Rev. Proc. 76-47 seeks to determine whether grants in the context of an employer-related grant program are scholarships or fellowships under IRC 117(a), while Rev. Proc. 80-39 examines whether educational loans in such a context are objective and nondiscriminatory within the meaning of IRC 4945(g).

Of particular interest is the alternative allowing scholarship grants or educational loans to ten percent of the number of eligible children of employees, whether or not they submit an application. For purposes of determining how many employees' children are eligible for an educational grant or loan under the ten percent test, a private foundation may include as eligible those children who state in writing, through a survey or other format, that: (1) they meet the foundation's eligibility requirements; (2) they are enrolled in or have completed a course of study preparing them for admission to an educational institution for which the grants or loans are available, have applied or intend to apply to such institution, and expect, if accepted, to attend the educational institution in the immediately succeeding academic year; or, (3) they currently attend an educational institution for which the grants or loans are available but are not in the final year for which an award may be made.

A significant question that has been asked in the past is whether an employer-related scholarship plan, created pursuant to a collective bargaining agreement, can satisfy Rev. Proc. 76-47 and IRC 117. This question also has relevance for purposes of exemption qualification under IRC 501(c)(3). It appears that the existence of a collective bargaining agreement would conclusively establish the lack of disinterested motivation that is a prerequisite to qualification of a scholarship or fellowship as nontaxable under IRC 117. See *Bingler v. Johnson*, 394 U.S. 741(1969). Moreover, notwithstanding Rev. Proc. 76-47 and IRC 117, collectively bargained scholarship plans for employees' children cannot be said to be charitable within the meaning of IRC 501(c)(3) because of the private

interests redounding to the employer and by virtue of the "bargained for" educational benefit inherent in these types of plans.

In the case of Ohio Teamsters Educational and Safety Training Trust v. Commissioner, 77 T.C. -, No. 16 (August 4, 1981), the U.S. Tax Court held that a trust created under a collective bargaining agreement to award educational grants to employees and their families is not exempt under IRC 501(c)(3). The court concluded that the trust's primary purpose was to provide a form of indirect compensation to employees covered by the collective bargaining agreement and, therefore, the trust was not operated exclusively for IRC 501(c)(3) purposes even though its activities would to some extent further charitable purposes.

The application of Rev. Proc. 76-47 is illustrated in Rev. Rul. 79-131, 1979-1 C.B. 368, and Rev. Rul. 79-365, 1979-2 C.B. 389. Rev. Rul. 79-131 considers a private foundation that was created and funded by a for-profit company that grants scholarships, based on objective standards, for the education of children of a particular community, regardless of whether the parents are employed by the company. The scholarship program is not an "employer-related" grant program subject to the guidelines of Rev. Proc. 76-47. Rev. Rul. 79-365 holds that a private foundation's scholarship program for children of deceased or retired employees is an "employer-related" grant program subject to the guidelines of Rev. Proc. 76-47. In addition, where a private foundation pays grants to an organization that is not a private foundation to provide scholarships to children of a particular employer, such grants are employer-related and therefore subject to Rev. Proc. 76-47. See Rev. Rul. 81-217, 1981-36 IRB 16. Another aspect of Rev. Proc. 76-47 arises in situations where two or more foundations make grants to a single employer. In this regard, the combined number of grants made by the foundations involved in the employer-related program should not exceed the percentage guidelines of Rev. Proc. 76-47 in the aggregate.

Prior to the issuance of Rev. Proc. 76-47, a number of employer-related grant programs were approved under IRC 4945(g)(1) that did not conform to the guidelines of Rev. Proc. 76-47. Rev. Proc. 77-32, 1977-2 C.B. 541, provides that foundations could rely on such rulings only until March 31, 1978. Thus, any organization operating a program not complying with Rev. Proc. 76-47 should have requested a new ruling under IRC 4945(g)(1) prior to that date. If this has not been done, any grants awarded after March 31, 1978, could constitute taxable expenditures under IRC 4945(d)(3).

A similar rule applies in the case of employer-related loan programs. Sec. 5 of Rev. Proc. 80-39 provides that a foundation may rely on a ruling letter approving its loan program through March 31, 1981.

5. Imposition of Tax and Correction

As indicated earlier, IRC 4945(a) imposes a first level tax of 10% on a prohibited taxable expenditure of a private foundation. A first level tax of 2 1/2% (up to a maximum aggregate amount of \$5,000) is also imposed on a foundation manager who knows that the expenditure to which he agrees is a taxable expenditure and such agreement is willful and not due to reasonable cause. See Reg. 53.4945-1(a)(2).

Where a first level tax is imposed and the expenditure in question is not corrected within the correction period ("taxable period" for taxes assessed after December 24, 1980), a second level tax of 100% is imposed on the amount of the taxable expenditure made by a private foundation. In addition, a second level tax of 50% of the amount of the expenditure (up to a maximum aggregate amount of \$10,000) is imposed on the foundation manager if he refuses to agree to part or all of the correction. As indicated in IRC 4945(i)(1), correction of a taxable expenditure in the case of scholarships involves recovering part or all of the expenditure to the extent possible and where full recovery is not possible, by any additional corrective action the Commissioner may prescribe. See Reg. 53.4945-1(d)(1).

Special rules, relating to taxable expenditures under IRC 4945(d)(3), are found at Reg. 53.4945-1(d)(3) and apply in cases where there is a taxable expenditure due to a failure to obtain advance approval. In this regard, correction is accomplished by obtaining approval of the grant-making procedures and establishing to the satisfaction of the Commissioner that: (1) no grant funds have been diverted to any use not in furtherance of a purpose specified in the grant; (2) the grant making procedures instituted would have been approved if advance approval of such procedures had been properly requested; and, (3) where advance approval of grant making procedures is subsequently required, such approval is properly requested. Procedures for agreed and unagreed cases are set forth in IRM 7(10)62.6 and IRM 7(10)62.7. Also, in certain circumstances, advance approval of proposed corrections may be requested. See IRM 7(10)62.8.

Delegation Order No. 139 (Rev. 5) delegates to District Directors and the Regional Directors of Appeals the authority to extend the correction period under IRC 4945.

6. Racially Restricted Scholarship Trusts

This part surveys the question of exemption qualification under IRC 501(c)(3) of private scholarship trusts with racial restrictions. This threshold question is also relevant in connection with whether such trusts that are classified as private foundations otherwise satisfy the provisions of Reg. 53.4945-4(b) as they relate to the selection of scholarship recipients on "an objective and nondiscriminatory basis." It should be emphasized that this survey is not intended to be conclusory but merely illustrative of the technical considerations involved in resolution of this question. The question of discrimination on the basis of national origin or religion in the context of private scholarship trusts is not addressed although a somewhat similar analysis could be applied.

Rev. Rul. 71-447 provides that a private school that does not have a racially nondiscriminatory policy as to students does not qualify for exemption under IRC 501(c)(3). This conclusion is based on the general premise that racial discrimination in education is contrary to federal public policy. The revenue ruling advances three premises in order to reach its conclusion:

- (1) An educational trust must be a common law charity in order to be exempt under IRC 501(c)(3),
- (2) Every charitable trust is subject to the requirement that its purpose may not be illegal or contrary to public policy; and,
- (3) As reflected in numerous federal statutes and court cases, there is a clear public policy against racial discrimination, whether public or private.

The conclusion of Rev. Rul. 71-447 has specifically been upheld by the courts. Green v. Connally, 330 F. Supp. 1150 (D.D.C. 1971), aff'd per curiam sub nom Coit v. Green, 404 U.S. 997 (1971); Goldsboro Christian Schools, Inc. v. United States, 436 F. Supp. 1314 (E.D.U.C. 1977).

As the Green and Goldsboro courts indicated, prominent examples of the public policy against racial discrimination are the 13th and 14th Amendments to

the Constitution, the Civil Rights Acts of 1866, 1870, and 1964, and Brown v. Board of Education, 347 U.S. 483 (1954), and its numerous legal progeny. The courts have also repeatedly and consistently struck down every form of state involvement with, and assistance for, racially discriminatory private schools. See Gilmore v. City of Montgomery, 417 U.S. 556 (1974), relating to exclusive use of city recreational facilities by segregated private schools, and Norwood v. Harrison, 413 U.S. 455 (1973), relating to textbook assistance to private discriminatory schools. The Supreme Court has also held that under the Civil Rights Act of 1866, private schools may not deny admission on the basis of race. See Runyon v. McCrary, 427 U.S. 160 (1976). Also, where state authorities act as trustees of a racially restricted private educational trust, the trust will be invalidated on constitutional grounds. Pennsylvania v. Board of Directors, 353 U.S. 230 (1957). Numerous federal regulations also prohibit racial discrimination in the provision of educational assistance. See, for example, 45 C.F.R. Section 80.3(b).

In view of this public policy against racial discrimination in education, a strong basis exists for concluding that a racially restricted private scholarship trust does not qualify for exemption under IRC 501(c)(3). This basis is found in the longstanding rule that every charitable trust is subject to the requirement that its purposes may not be illegal or contrary to public policy. This is one of the three premises advanced by Rev. Rul. 71-447, and may be viewed as equally applicable to private scholarship trusts that restrict grants on the basis of race.

However, there are equally plausible arguments, under the right circumstances for concluding that a racially restricted scholarship trust would not be deemed incompatible with exemption qualification under IRC 501(c)(3). This view is based on the belief that in practice, it cannot be said that a private trust whose beneficiaries are restricted to members of a particular race necessarily fosters racial discrimination in education.

The advancement of education has universally been held to be a purpose "of such social interest to the community as to fall within the concept of charity." Restatement (Second), Trusts Section 368 comment b (2d ed. 1959) (Restatement); Bogert, Trusts & Trustees Section 375 (2d ed. 1964) (Bogert); IV Scott on Trusts Section 270 (3d ed. 1967) (Scott). While the law and society favor protection of the ability to create educational trusts, a trust for the advancement of education will not be a charitable trust if the beneficiaries are not of a sufficiently large or indefinite class so that the community is benefited and interested in the enforcement of the trust. Restatement Section 370; Bogert, Section 375 at 117-118; Scott Section 370.6.

As a general proposition, the courts have upheld the validity of a private gift for charitable purposes despite a provision in the trust indenture limiting or excluding beneficiaries on the basis of race. 15 Am. Jur. 2d Exclusion of Beneficiaries on Basis of Race or Religion Section 74 (1976); Restatement Section 370; Bogert Section 375 at 117-118; Scott Section 370.6; Annot., Validity and Effect of Gift For Charitable Purposes which Excludes Otherwise Qualified Beneficiaries Because of their Race or Religion, 25 A.L.R. 3d 736 (1969 and Supp. 1980).

There appears to be no case involving a private scholarship trust in which such a racial limitation or exclusion was declared invalid or illegal; rather in the large majority of cases in which such a limitation was at issue, the courts utilized the equitable doctrine of cy pres to strike out the racial limitation or exclusion on grounds such as impracticability or impossibility of administration. See e.g., Lockwood v. Killian, 179 Conn. 62 (1979); Pennsylvania v. Brown, 392 F. 2d 120 (3d Cir.), cert. denied, 391 U.S. 921 (1968), (affirmed District Court judgment enjoining trustees of Girard College from denying admission to otherwise qualified applicants on the basis of their race); Smith v. Moore, 225 F. Supp. 434 (D.Va. 1963), remanded on other grounds, 343 F.2d 594 (4th Cir. 1965) (court did not believe that settlor intended to provide hospital for white persons only, or, in the alternative, no hospital at all), Coffee v. William Marsh Rice University, 408 S.W. 2d 269 (Tex. Civ. App. 1966) (trust for white inhabitants of Houston held valid and not contrary to public policy, but court allowed university to choose applicants of any race because condition made operation of trust impractical and an impediment to successful operation of the university); Wachovia Bank & Trust Co., N.A. v. Buchanan, 346 F. Supp 665 (D.D.C.), aff'd without opinion, 487 F.2d 1214 (D.C. Cir. 1973) (scholarship for white boys and girls residing in county cy pres invoked, trust upheld, racial restriction stricken); Bank of Delaware v. Buckson, 255 A.2d 710 (Del. Ch. 1969) (application by white youths or white young men, white stricken); In re Will of Potter, 275 A.2d 574 (Del. Ch. 1970) (aid poor white persons, white stricken); Trammell v. Elliott, 230 Ga. 841, 199 S.E. 2d 194 (1973) (poor white children white stricken) Wooten v. Fitz-Gerald, 440 S.W. 2d 719 (Tex. Civ. App. 1969) (aged white men white stricken).

In light of the above, one might perceive a hesitance on the part of the courts to strike down racially restricted educational trusts in toto. Rather, the courts appear to find racial limitations as "impossible" or "impracticable." Of course, where state action is involved, the courts have not been hesitant in characterizing such provisions as invalid on constitutional grounds. In light of these

considerations, it may be more advisable to adopt a facts and circumstances test, rather than a boilerplate rule, that racially limited scholarship trusts are not charitable per se.

In this regard, the Service has adopted a similar position in an analogous situation in section 4.05 of Rev. Proc. 75-50, which states that:

Financial assistance programs favoring members of one or more racial groups that do not significantly derogate from the school's racially nondiscriminatory policy similarly will not adversely affect the school's exempt status.

In light of these additional comments, for example, where a racially restricted private scholarship trust provides financial assistance through the grant program of a major university that practices a racially nondiscriminatory policy as to students, it would be difficult to characterize the trust as discriminatory per se. However, if such a trust was related to a school that had a racially discriminatory policy, the conclusion would be unavoidable that the trust would be contributing to racial discrimination in education. Also, if a school had a racially nondiscriminatory policy, but the restricted trust accounted for a large share of financial assistance, the trust could be deemed as detracting from the school's nondiscriminatory policy and deemed non-exempt on that basis. Also, such a trust (not having a relationship to a school or university) directed at potential grantees in a particular community might also be considered discriminatory and therefore not exempt.